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LONG-RUN RANGES
Donald L. Kohn

At this time the FOMC is required both to reconsider its 1988 ranges for money and credit and to establish on a tentative basis ranges for 1989. I will be briefly reviewing the 1988 situation, before discussing some of the issues the Committee may want to consider in assessing the 1989 ranges.

With respect to 1988, M2 and M3 are now in the upper halves of their target ranges, though well below the upper ends of those ranges. The strength in M2 relative to income--reflected in the 3/4 percent estimated rate of decline in its velocity in the first half of the year--is partly attributable to the drop in interest rates from October through February, and also perhaps to some special factors boosting M2 demand. In any event, the rise in rates over recent months seems already to be damping the quantity of M2 demanded and would be expected to lead to slower M2 growth in the second half of the year than in the first, even if interest rates were to remain at current levels. This would leave M2 close to, though possibly a little above, the midpoint of its range. M3 growth is expected to remain well above the midpoint of its range, given the tendency for rising rates to encourage borrowers to favor the short-term and floating rate obligations issued and held by depository institutions, but it is not seen as threatening the upper end of its range. Debt is running around the middle of its range and should remain in that general area.

Under these circumstances, the staff saw no need to propose alternatives in the bluebook to the existing 1988 ranges. Reducing them seemed inappropriate at a time when the money aggregates are running high in their ranges, and raising them, say for M3 to more symmetrically encompass the expected outcome, would seem to send the wrong message about the Committee's intentions for policy in 1988 and for money growth over time. Moreover, any tendency for money to accelerate to threaten the upper ends of the existing ranges might well signal unexpected strength in the economy that the Committee would want to react to rather than to accommodate.

Consideration might be given to narrowing the ranges. Being halfway through the year, it ought to be possible to give a more precise idea of where one wants to end up than is true in February. This should be especially true this year, given the unusual uncertainties in the outlook earlier in the year associated with the effects of the stock market crash. However, the Committee has never before chosen to take advantage of the information at midyear to narrow the ranges--though it never before had 4 point ranges. And, the most logical narrowing would seem to involve raising the lower ends, especially for M3, which wouldn't appear on the surface to be consistent with an anti-inflationary stance.

For 1989 the bluebook presented three alternative sets of ranges. Alternative I, which would retain the 1988 ranges, is more consistent with a view that the risks in the economy are not tilted toward greater inflationary pressures and that the ranges should provide about as much scope for an easing of policy, should that prove needed to support growth, as for a tightening. A more even distribution of risks than in the staff forecast might be seen, for example, if strength in the dollar were to retard improvement in the trade balance, or if fiscal policy turned out tighter than expected. This alternative might also be interpreted as allowing for more rapid expansion of nominal income than the other alternatives, on the thought that the structure of labor markets would permit the accommodation of one-time increases in some prices--for example, for imports--without entrenching them in wages and in a more general inflation process.

Alternative II would reduce all the ranges by 1/2 of a percentage point, suggesting a concern about restraining income growth to a degree and moving toward money growth ranges over time that are more consistent with price stability. However, although the staff is forecasting about 4 percent growth in M2 in 1989 for the income and interest rates in the Greenbook, some model results, plus the possibility of surprises in money demand, suggest that the 3-1/2 percent lower end of alternative II for M2 might be uncomfortably constraining, if the Committee wishes to damp inflation over 1989 and underlying demands on the economy turn out to be as strong as in the staff forecast. At least, given the interest responsiveness of M2, alternative II allows essentially no room for greater restraint than assumed by the staff. The likelihood of a shortfall for M3 or debt would be much smaller, given their lower interest sensitivities and expectations that they would be near the middle of the alternative II ranges under the staff forecast.

Alternative III would allow a little more room for policy restraint or for a sharper than expected rise in M2 velocity. The full one percentage point reduction in the M2 range has a recent precedent in the one point reduction in the midpoints of ranges between 1987 and 1988. Also, the higher range for M3 than for M2 is consistent with the long-run relationship of their velocities; reflecting this relationship, in the past, ranges for M3 have on occasion been above those for M2. The 7 percent upper end of the M2 ranges under this alternative is low compared with M2 growth rates over the 1970s and most of the 1980s. For the most part, however, those growth rates were registered when nominal income and prices were increasing fairly rapidly, or when the economy was in recession and interest rates were falling. Alternative III definitely is geared toward a situation in which the risks are seen more on the side of strength in the economy and inflation, given high levels of resource utilization, than of weakness, and in that context, one in which the Committee is committed to resisting tendencies for income growth to run much above 6 percent.

As Mike has noted, however, even the staff forecast implies only meager progress toward price stability in 1989 and 1990. The table distributed to the Committee marked "alternative long-run monetary policy strategies" repeats the baseline forecast and gives another set of policy assumptions designed to reduce inflation in 1990 by an additional 3/4 of a percentage point. As with the constant interest rate scenario discussed in the chart show, the results are based on the underlying assessment of the economy in staff judgmental forecast, using various econometric models to gauge how key variables would have to differ from their values in that forecast to achieve the desired end. They should be considered less an exact road map than a general indication of the sorts of policies that might be involved and the responses of the economy.

One aspect of this alternative that stands out is the amount of additional monetary tightening needed over the near term to get inflation down to 3 percent in 1990. In this scenario, the 3-month Treasury bill rate rises nearly 2 percentage points over the next two quarters and a bit further in 1989, while M2 growth is reduced to 4 percent over the second half of the year and only 1-1/2 percent in 1989. Largely as a consequence of policy restraint, the dollar would fall less rapidly, especially over the near term.

This severity results in part from the fairly long lags in the models between policy impulses and their effects on prices, as Mike has already discussed, which dictate a sharp tightening in the latter part of 1988 to damp inflation significantly in 1990. In addition, the desired slowing of inflation rates must occur in the face of continuing upward movement in the prices of imports, though at a slower pace, necessitating more substantial moderation in other prices. The models make no allowance in wage and price setting behavior for any enhanced credibility of the Federal Reserve's pursuit of its objective for price level stability. In fact, the evidence of such an effect, even after late 1979, is mixed at best, but a policy tightening of the magnitude envisioned at the current rate of inflation certainly would get the attention of the relevant parties and might speed the adjustment process. Moreover, this alternative leaves the economy at the end of 1990 in a position that would seem to suggest considerable weakness in activity and increase in unemployment in 1991, though also substantial further gains against inflation. Clearly, in the context of the models' structures, if the Committee were to accept a more gradual downward course for inflation, something between the baseline and the alternative might be appropriate, with a smaller increase in unemployment that developed more slowly.

Such "fine-tuning" of policy paths is probably pushing the exercise beyond its inherent limitations. The point remains, however, that if the staff's assessment of the underlying strength of demand in the U.S. economy and the pressures on exchange rates is about on track, a decision to seek a greater slowing of inflation than in the base line forecast probably calls for even lower ranges for money growth in 1989, especially M2, than in the alternatives in the bluebook--for example a 2 to 6 percent M2 range. This alternative might even be considered more consistent with the baseline forecast, since it is symmetrical around the 4 percent M2 growth expected in that forecast. Such a range, however, would involve a full 2 percentage point decrease from 1988 ranges. And given the central tendency of FOMC members forecasts that imply nominal GNP growth of around 6 percent, it would be tantamount to announcing an FOMC expectation of rising interest rates to obtain the needed velocity increase.

An additional problem with moving promptly to very low money growth ranges, and a more general complexity of formulating a long-run strategy for money growth in a world with appreciable interest sensitivity of money demand, is illustrated by the projected path of M2 under both the base line and the lower inflation strategies. In both cases, money growth strengthens in 1990 relative to 1989 even though nominal income growth is unchanged or slows. This is a function of the response of M2 to the decline in nominal interest rates resulting from lower inflation rates and a softer economy. At some point, as inflation comes down, nominal interest rates will have to decline and the Federal Reserve will need to allow money growth to accelerate to avoid high real rates and real output below its potential. This implies that a strategy of reducing money growth year after year will not necessarily be optimal. It also means that if the ranges were reduced to 2 to 6 percent, there is some chance that at some point the ranges may have to be raised temporarily or money growth in excess of the ranges tolerated for a time.

Alternative Long-run Monetary Policy Strategies
(Percent change, QIV to QIV, unless otherwise noted)

	1988	1989	1990
M2			
Base line	6.2	4.0	5.4
Lower inflation	5.6	1.4	2.5
Treasury bill rate (percent, fourth quarter)			
Base line	7.1	7.8	7.4
Lower inflation	8.4	9.6	9.2
G-10 weighted dollar exchange rate			
Base Line	-4.5	-7.5	-7.5
Lower inflation	-.6	-5.6	-6.7
GNP fixed-weight deflator			
Base line	4.3	4.2	3.8
Lower inflation	4.3	4.0	3.1
Real GNP			
Base line	2.9	2.1	2.2
Lower inflation	2.7	.7	.4
Unemployment rate (percent, fourth quarter)			
Base line	5.7	5.9	6.0
Lower inflation	5.7	6.5	7.3

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Short-run Policy Alternatives
Donald L. Kohn

Monetary policy decisions are being made today in a somewhat different environment of asset price movements than we have been used to over most of the past year or so. Of course, for most of that period a weak dollar and rising bond yields had reinforced the analysis that policy had to tighten to head off accelerating inflation. The question is whether the recent improvements in bonds and the dollar suggest that interest rates have been raised enough or at least that the recent trajectory of firming should be moderated.

Both the causes and the implications of these recent developments are difficult to interpret. On balance, as both Peter and Sam indicated, it would seem that incoming information on both trade and the economy, along with the actions of the Federal Reserve, allayed some of the market's worst fears about accelerating inflation, a declining dollar, and the need ultimately for a very much sharper tightening of monetary policy. This change in attitude made long-term dollar securities much more attractive, in a situation in which many dealers and other professionals had thought that prices would continue to head down.

The very volatility and noise in these asset prices should strike a note of caution in any reaction to them. The rather large day-to-day price movements in the bond market suggest that current levels are not held with much conviction, and recent movements could easily be reversed. In some sense, such a reversal is embedded in the staff forecast, though I should hasten to add that that forecast is not so sensitive to relatively small rate movements that it is incompatible with the current configuration for a time. Even so, the underlying assessment of that forecast is that pressures on prices and the pace of the external adjustment process at some point will show through in substantial increases in short- and long-term interest rates and declines in the dollar.

Even if strength in the dollar and bonds persists, or at least is not reversed, the following points may be relevant to their interpretation for policy.

1. Despite the recent rally in the bond markets, at 8.90 percent the yield on 30 year Treasury bonds is quite high relative to the inflation of recent years, and certainly relative to the FOMC's goal of price stability. And this yield is 1/2 percentage point above earlier this year and 1-1/2 percentage points above its level at the beginning of 1987. Investors apparently are still of the view that on balance the risks are weighted toward additional price pressures.

2. The yield curve still slopes upward, albeit by considerably less than a few weeks ago. The differential between short- and long-term rates is not at a level that in the past has suggested an impending recession, or even necessarily a very soft economy, especially if one makes some allowance for the expected Treasury bond shortage. It seems likely that investors still anticipate that monetary policy will continue to firm, though by less than in the staff forecast.

3. Real short-term rates have risen along with the tightening in monetary policy, but their increase from earlier this year probably has been less than the increase in nominal rates, given some intensification of at least short-term inflation expectations seen in the various surveys. Moreover, these rates are probably not much higher than they were in the spring of 1987, which was compatible with growth in excess of potential for the last few quarters. The recent direction of real long-term rates is even more difficult to determine. If the extreme inflation fears have abated, so too probably has the mean of expected inflation over a long period. This suggests that at least a portion of the very recent declines in bond yields did not represent a drop in real rates. To the extent real rates did decrease, their impact on the economy would depend on whether that decrease was in response to a weakening demand picture, or to a shift in demand for bonds, perhaps from internationally diversified investors. The latter could represent a net stimulus to the economy.

4. The implications of the dollar's strength are especially hard to read. If the staff assessment is correct, this is only a temporary detour in the downward movement of the dollar. As such, if it persisted, it could slow adjustment and damp growth, as Ted pointed out yesterday, in a sense supplementing the tighter monetary policy of recent months and reducing, at least for a time, the degree of further policy restraint needed. If, however, the dollar remains firm because the trade balance continues to improve at a rapid pace, the implications would be somewhat different. The improvement in the trade balance still

will require restraint on domestic demand to free resources and forestall an intensification of price pressures. In this case, policy might have to be firmed substantially even in the face of some strength in the dollar.

5. With all the gyrations in these markets, money growth generally has come in about where the Committee expected. Growth in M2 is a touch stronger, especially in its M1 component. Data received in the last few days now suggest M2 growth in June of 6-1/2 percent, rather than the 6 percent in the bluebook, and M1 growth of 9-1/2 percent. We have interpreted the strength in demands for liquid components of M2 as a function of uncertainty about future interest rate movements, rather than a symptom of greater growth in transactions and income than expected. June M2 growth remains well below the rates of earlier this year, and we continue to expect a further slowing in the months ahead in lagged response to previous increases in interest rates and opportunity costs. The most recent data would not cause us to alter our assessment of the growth rates of M2 or M3 given the alternatives in the bluebook.

6. Finally, uncertainties about the impact of these developments might imply some caution in immediate policy moves, though not a change in course if the risks were still seen to lie on the side of some uptick in prices, given current levels of resource utilization. If exacerbating recent strength in the dollar were a particular concern, because of its potential effect on external adjustment, or because of a possible demonstration effect of U.S. actions on the general level of interest rates in industrialized countries, the foreign exchange markets

might be given more prominence in the directive and short-run policy implementation.